



HENRY WAXMAN WAS WRONG

by Graef Crystal

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Henry Waxman, the chairman of the House Oversight and Government Reform Committee, recently took on Richard Fuld, who, improbably enough, is still the CEO of bankrupt Lehman Brothers Holdings Inc. In a remark quoted many times, Mr. Waxman fixed Mr. Fuld in his owl-like gaze and said to him, no doubt in righteous anger: “You did well when the company did well and you did well when the company did poorly”.

We know that Mr. Fuld did extraordinarily well over his long tenure as CEO. (Please see my earlier article: “Richard Fuld – Two Words Meaning Total Failure”, published last month.) But is Congressman Waxman right? Did Mr. Fuld’s pay not vary according to Lehman’s performance?

Pay Defined

I went back and looked at Mr. Fuld’s pay from 1995 through 2007. But in this case, I wanted to see what his board intended to give him, as opposed to what he eventually earned (and subsequently lost). Hence, I used a different definition of pay, combining:

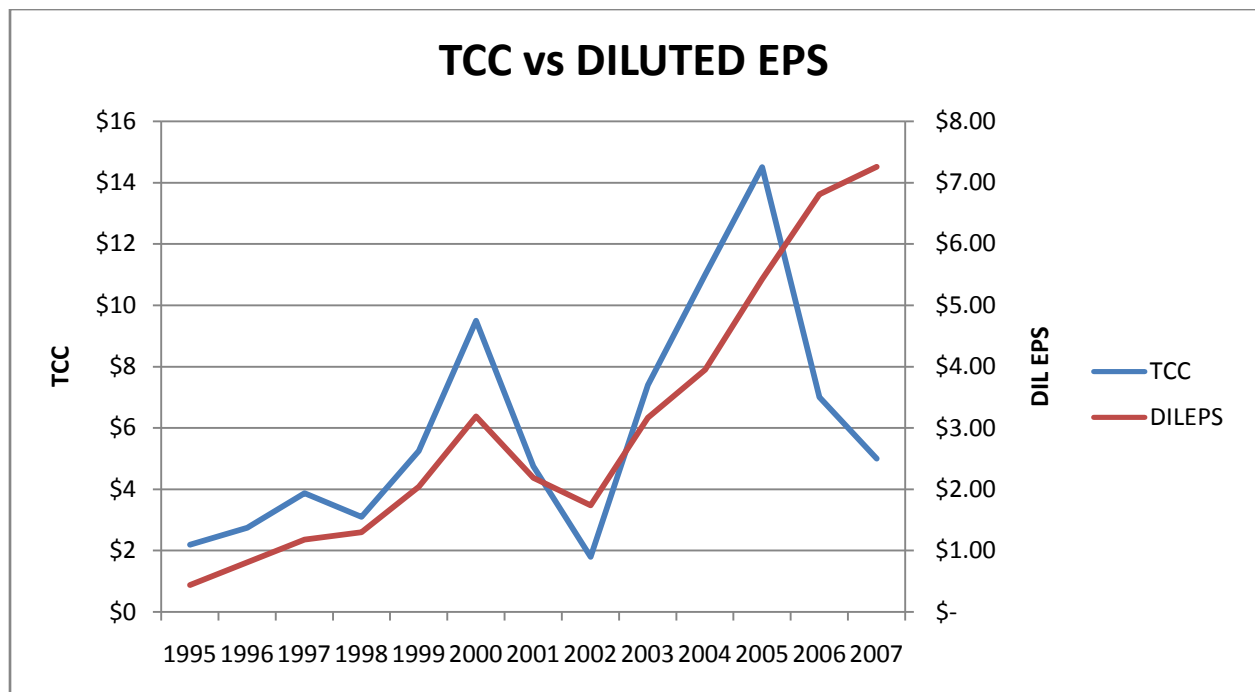
- Base salary.
- Bonus for annual performance.
- The value at grant of free shares granted during the year.
- My estimate for the present value at grant (using the Black-Scholes model) of stock options granted during the year. (The terms “present value” and “grant date fair value” are synonymous.)
- The “target” value of prospectively-granted performance shares or units awarded during the year.

- And, as defined by the U.S. Securities and Exchange Commission, miscellaneous compensation.

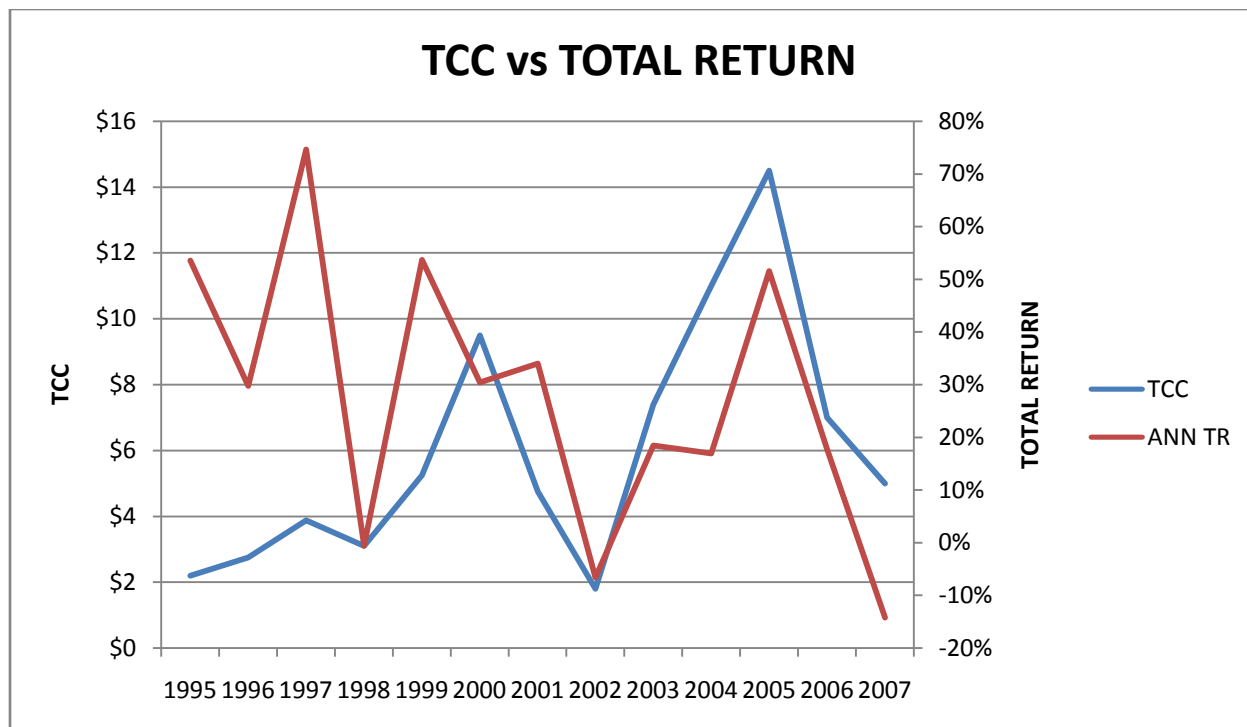
Fuld's Total Current Compensation

Let's start here by focusing on the sum of salary and bonus, which is often called Total Current Compensation or Total Cash Compensation. (Either way, its nickname is TCC.)

A regression analysis involving TCC as the dependent variable and Diluted EPS as the independent variable produced an r-squared of 0.56, meaning that you can account for 56 percent of the variation in Fuld's TCC by knowing Lehman's Diluted EPS. The probability of this result having occurred by chance is only three chances in 1000.



But a regression involving TCC as the dependent variable and one-year total return as the independent variable produced an r-squared of only 0.03, meaning no significant relationship whatsoever.



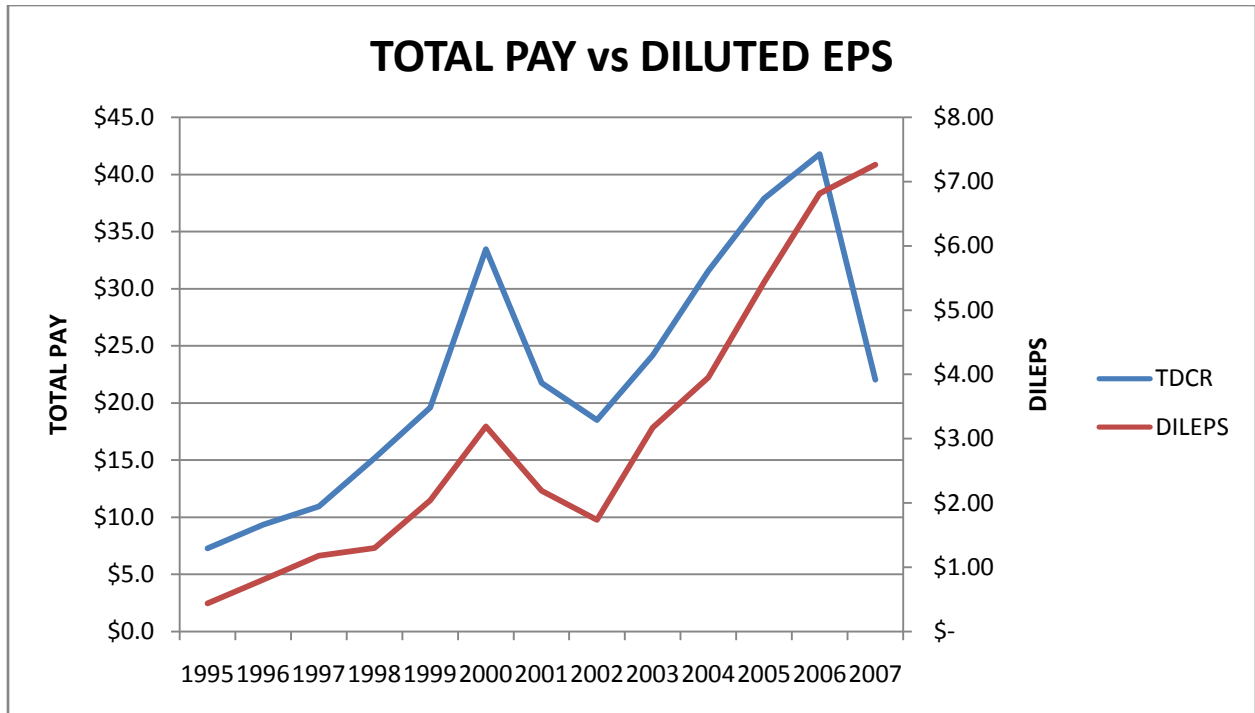
However, looking at the immediately-above chart, it appears that as we move toward the present, Mr. Fuld's total pay does in fact better mirror total return to shareholders. It is the early years that seem to have destroyed the correlation.

Fuld's Total Pay

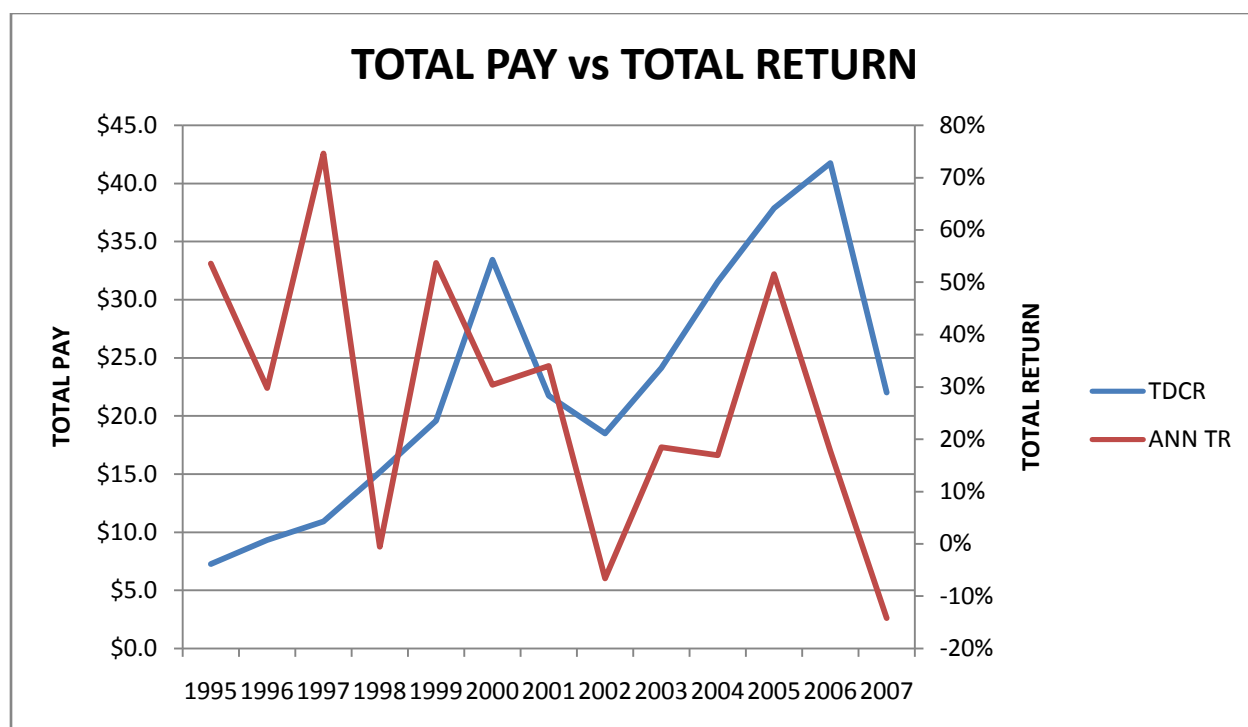
Now, let's look at total pay:

But first, it needs to be emphasized that my total pay series picks up the normative value of stock options, not the actual gains, if any, that will eventually materialize. And it picks up the value at grant of free shares, which may or may not be the value when those shares become vested.

A regression analysis involving total pay as the dependent variable and Diluted EPS as the independent variable produced an r-squared of 0.84, meaning that you can account for 84 percent of the variation in Fuld's total pay by knowing Lehman's Diluted EPS. The probability of this result having occurred by chance is less than 1 in 1000.



But a regression involving total pay as the dependent variable and one-year total return as the independent variable produced an r-squared of only 0.06, showing that there was no significant relationship between the two series.



Once again, we find the same pattern, i.e., a disconnect between total pay and total return in the earlier years and a better match-up in the more recent years.

So Henry Waxman is wrong if you use as your performance metric Diluted EPS. Mr. Fuld's TCC and his total pay were quite sensitive, though not perfectly sensitive, to changes in Diluted EPS.

But Henry Waxman is at least partially right if you use as your performance metric one-year total return. But his "rightness" applies more to the earlier years than the more recent years.

Of course, one can raise the following response to all of the above: Granted that Mr. Fuld's TCC and total pay might have moved pretty well in line with his company's Diluted EPS, but look at the sheer volume of pay he received. Leaving aside the years 1994 through 1996, there was no following year in which he earned less than \$11 million.

So viewed in that context, Congressman Waxman's remark that "...You did well when the company did poorly" seems to ring true.

Except that, until the very end, Lehman didn't do poorly. Diluted EPS in the 1997-2007 period rose from \$1.18 for 1997 to \$6.81 for 2006 and \$7.26 for 2007. The compounded annual growth between 1997 and 2007 was 19.9 percent. If you extend the measurement period to cover 1994 through 2007, the compounded annual growth rises to 44 percent.

For another statistic, Lehman's average annual return on common equity for the 1997 through 2007 period was a solid 18.6 percent.

In short, before the Lehman crash, Mr. Fuld's performance was quite impressive, and he was paid quite impressively – far more than most reasonably-minded folks would say was fair. But hey, that is – or was – Wall Street.

(There's much talk that the accounting at Lehman was wacky and that the Diluted EPS numbers I have just cited contained a lot of hot air. If that is so, then new charts based on revised Diluted EPS figures would obviously tell a different story. For my part, I have heard the charges, but so far as I know, no overwhelming evidence has as of this writing been produced to show that Lehman deliberately cooked its books.)

Rough Justice

But at the end, rough justice seemed to prevail. Between 1996 and 2007, Mr. Fuld increased his ownership of Lehman shares to 10.9 million from 761,000. I rather doubt that he used a lot of his own funds to buy those millions of shares. Rather, he more likely converted into shares all, or a goodly part of his after-tax option gains, which, on a pre-tax basis, totalled \$363 million over the 12 year period. And he may also have retained a substantial number of the roughly six million free shares he was granted, after first selling enough to pay his tax bill.

When Lehman collapsed, though, those 10.9 million free shares turned out to be essentially worthless. And if that's not non-pay for non-performance, I don't what is.

Everybody's mad at Dick Fuld these days. He has become the human face of an almost incomprehensible financial crisis. But it is a canard to assert, as Henry Waxman did, that there was no relationship between his pay and his performance.

2009 marks Graef Crystal's 50th anniversary in the executive compensation field. He has been a director of compensation for General Dynamics and Pfizer, worked as a consultant for Booz, Allen & Hamilton, served as worldwide practice director at Towers Perrin for 18 years, was a professor at the University of California at Berkeley's Haas School of Business for 10 years and a syndicated columnist for Bloomberg News for almost nine years. He has written six books and more than 1,600 articles on executive pay. In the Spring of 2009, he will be teaching a course in executive compensation at the University of California at Berkeley's Boalt School of Law.